

CAVEAT EMPTOR:
LET THE BORROWER BEWARE OF THE SUBPRIME MORTGAGE
MARKET

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Homeownership epitomizes for many, the American Dream, one that was attained by thousands when the homeownership rate peaked in 2005. With the emergence of the subprime mortgage lending market in the early 1990s, lending institutions began extending credit to borrowers who otherwise would be unable to obtain large loans, and as a result, some traditionally unqualified borrowers obtained and used these loans to purchase a home or refinance their mortgage. However, this dream became a nightmare for thousands when they could no longer afford the high subprime interest rates, forcing them to become delinquent on their payments, lose their homes due to foreclose, or even file for personal bankruptcy. Although the subprime mortgage market is risky and can potentially lead to abusive lending practices and harmful affects on consumers, subprime loans are not inherently abusive and can offer several benefits. For consumers to reap those benefits and minimize their risks, they have to make informed decisions when navigating this market.¹ To alleviate some of the consequences consumers face, lenders and brokers must be subject to reasonable government oversight and accountability.

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¹ I use the word informed to mean that consumers actually understand the loan terms and risks and available loan options, which can be acquired through their own knowledge, from a lender or broker thoroughly explaining the loan and its expected costs overtime, or from another knowledgeable source. This enhanced use of the word informed is juxtaposed with labeling consumers as being informed merely because they received a wealth of loan documentation and may have signed a statement certifying their receipt and understanding of the material.

This Comment surveys the American subprime mortgage lending market and its affect on consumers. Part I addresses the development of the subprime mortgage market, the nature of subprime loans, and the reasons why they pose a high risk to consumers. Part II addresses the consumer benefits and costs associated with subprime mortgage loans. Part III discusses how consumers' psychology and behavior facilitates vulnerability to risks in the subprime market, and Part IV examines which consumer groups are most vulnerable to those risks. Finally, Part V proposes consumer and lender-oriented solutions as a means of protecting borrowers who transact in the subprime mortgage market.

I. NATURE OF SUBPRIME MORTGAGE LOANS

Since the homeownership rate in the United States peaked in 2005, new and existing home sales decreased by 18 and 8 percent respectively.² An assortment of mortgage loan options became recently successful in the prime and subprime markets, and non-standard mortgage products enabled many consumers, who otherwise would be unable to obtain mortgage loans, to gain access to credit.³ Subprime loans originated in the early 1990s, and by 2001 they constituted 8.6 percent of all loan originations and 20.1 percent in 2006.⁴ Researchers estimate that about five million households, or 7 percent of homeowners, currently have a subprime loan.⁵

Two primary causes of the origination of the subprime mortgage market are the increase in securitization and the elimination of usury law ceilings. Securitization is process of "pooling . . . loans to form securities, which are subsequently sold in the secondary market."⁶ In response to the

² JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *THE STATE OF THE NATION'S HOUSING: 2007*, at 15 (2007) [hereinafter 2007 HARVARD STUDY], *available at* <http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf>.

³ REN S. ESSENE & WILLIAM APGAR, JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS I* (2007), *available at* http://www.jchs.harvard.edu/publications/finance/mm07-1_mortgage_market_behavior.pdf (examining consumer and lender behavior regarding the changes in the mortgage market, explaining why credit, which was previously unavailable to certain consumers, was later extended to them, and why many consumers make unwise choices when selecting a specific mortgage product).

⁴ 2007 HARVARD STUDY, *supra* note 2, at 17.

⁵ *Id.*

⁶ Heather M. Tashman, *The Subprime Lending Industry: An Industry Crisis*, 124

deficiency of funds for residential loans during the Great Depression period, the federal government created the secondary mortgage market, and securitized mortgage loans were 23 percent of all outstanding residential loans in 1984 but increased to 52 percent in 1988.⁷ The added capital lenders often gain by securitizing mortgage loans allows them to extend credit to borrowers in the form of subprime loans.⁸

The development of the subprime market is also attributed to the elimination of state usury law ceilings on mortgage interest rates. Usury laws are a means of state regulation of interest rates, and several states established a default legal maximum interest rate.⁹ When applied to the mortgage market, usury ceiling laws provided that it was unlawful for lenders to charge specified high interest rates on mortgage loans.¹⁰ To protect their financial interest, lenders sought to impose higher rates on borrowers seeking credit who had little or poor credit history or otherwise adverse financial circumstances. Usury laws substantially limited the extension of high-risk credit to low-income and poor consumers.¹¹ After the enactment of the Depository Institutions Deregulation and Monetary Control Act of 1980,¹² which prohibited states from setting usury ceiling rates on first-lien mortgages, many states removed the interest rate caps on all other mortgages.¹³ Thus, otherwise unqualified consumers gained access to the mortgage lending market and were able to obtain loans.

In the current mortgage market, subprime loans serve a legitimate and integral function of providing access to credit to many borrowers with poor or no credit history or who otherwise do not qualify for standard prime loans. Regrettably some of these loans are sold or obtained irresponsibly;

BANKING L.J. 407, 410 (2007).

⁷ *Id.*

⁸ *Id.*

⁹ Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 301 (1995).

¹⁰ *See id.*

¹¹ *E.g., id.*; EDWARD M. GRAMLICH, SUBPRIME MORTGAGES: AMERICA'S LATEST BOOM AND BUST 16 (2007). (writing as former member of the Board of Governors of the U.S. Federal Reserve about the rapidly evolving mortgage market and the current increase in home foreclosures).

¹² 12 U.S.C. §§ 4a, 93a, 216, 216a to 216d, 226 note, 1735f-7a, 1831d (2000); 15 U.S.C. § 1646 (2000).

¹³ GRAMLICH, *supra* note 11, at 16.

borrowers enter into loans without fully understanding the terms or overestimate their ability to afford the loan, and coupled with the loan's unfavorable terms, several lenders engage in abusive lending practices to prey on unsuspecting borrowers.¹⁴ A study by the Center for Responsible Lending found that 2.2 million households with subprime loans that were originated between 1998 and 2006 either lost their home due to foreclosure or will likely default on their loan within the next several years.¹⁵ The Center predicts that 19.4 percent of all subprime loans originated in the current market will result in foreclosure.¹⁶

A. Subprime Loans are Unconventional Mortgage Products

Subprime mortgage loans are an alternative to the standard prime loans. Consumers with satisfactory credit history and who show a capacity to repay the loan (i.e., by providing documentation of regular and sustainable income), thus creating less risk for the lender, normally receive a prime loan.¹⁷ "The term 'subprime' refers to the credit characteristics of the borrower," not the interest rate at which the loan is offered.¹⁸ Borrowers

¹⁴ Press Release, Office of the Press Sec'y, The White House, President Bush Discusses Housing (Dec. 6, 2007), *available at*

<http://www.whitehouse.gov/news/releases/2007/12/20071206-9.html>.

¹⁵ ELLEN SCHLOEMER ET AL., CTR. FOR RESPONSIBLE LENDING, LOSING GROUND: FORECLOSURES IN THE SUBPRIME MARKET AND THEIR COST TO HOMEOWNERS 11 (2006), *available at*

<http://www.responsiblelending.org/pdfs/FC-paper-12-19-new-cover-1.pdf>

(Showcasing the high foreclosure rates in the recent subprime mortgage market and found that these high foreclosure rates were far higher than even the worst periods in the modern prime market).

¹⁶ *Id.*

¹⁷ Edward M. Gramlich, Former Member of the Bd. of Governors of the U.S. Fed. Reserve, Remarks at the Financial Services Roundtable Annual Housing Policy Meeting: Subprime Mortgage Lending: Benefits, Costs, and Challenges (May 21, 2004) [hereinafter 2004 Annual Roundtable Remarks], *available at*

<http://www.federalreserve.gov/boarddocs/Speeches/2004/20040521/default.htm>.

¹⁸ BD. OF GOVERNORS OF THE FED. RESERVE, EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2 (2001) [hereinafter FED. GUIDANCE FOR SUBPRIME LENDING], *available at*

<http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf>

with subprime loans normally have a deficient credit report, including delinquent payments and judgments against them, and they may have a questionable ability to repay the loan, as determined by such factors as credit scores and regularity of sufficient income.¹⁹

According to the U.S. Federal Reserve Board, subprime borrowers usually display a range of the following characteristics (not exhaustive since criteria may vary among lenders):

(1) two or more 30-day [delinquent payments] in the last 12 months, or one or more 60-day delinquencies in the last 24 months; (2) judgment, foreclosure, repossession, or charge-offs in the prior 24 months; (3) bankruptcy in the last five years; (4) relatively high default probability, [typically] evidenced by a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral posted as security for the loan); and/or (5) a debt service-to-income ratio of 50 percent or greater, or otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.²⁰

Subprime loans are loans offered to consumers displaying some of the above characteristics.²¹ Subprime loans typically have higher interest rates than prime loans to compensate for the increased credit risk to borrowers, and since borrowers with loans are more likely to enter into default, the loans also pose greater risks for lenders.²² For borrowers,

¹⁹ *Id.* Since credit scores are used in other lending markets as a somewhat reliable indicator of a borrower's ability to repay a loan, mortgage lenders factor in the score along with a consumer's level of existing debt and income when deciding whether to approve a loan and designate a borrower for a certain type of loan (i.e., prime or subprime); GRAMLICH, *supra* note 11, at 18-19.

²⁰ *Id.* at 2-3. FICO scores range from 300 to 850, where higher scores reflect better credit. Although acceptable or favorable credit criteria varies with specific lenders, a good credit score is typically above 700, while a score around or below 600 could indicate poorer credit, leading lenders to charge higher rates or deny a credit application. For example, based on interest rates as of February 27, 2008, borrowers in a 30-year fixed-interest mortgage who have a 760-850 FICO score may get a 5.942 percent annual percentage rate (APR) while those with a score of 620-659 may be at 7.258 percent interest rate. *See generally* <http://www.myfico.com> (last visited Feb. 28, 2008).

²¹ FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 2-3.

²² 2004 Annual Roundtable Remarks, *supra* note 17.

subprime loans are distinguished from prime loans in that subprime loans have higher upfront and continuing costs.²³ Costs connected with originating the mortgage application, like application and appraisal fees are upfront costs, and continuing costs are those “associated with maintaining the mortgage such as mortgage insurance payments, principal and interest payments, late fees, and property taxes.”²⁴ For lenders, the decision to originate a prime or subprime loan is based on the predicted costs associated with the probability that a borrower will prepay the loan or default on the payments, and the likelihood that the market interest rate will change in a way that disfavors the lender.²⁵ Lenders are also concerned about the risk of decreased housing values. Lenders use prepayment payment penalties as a way to discourage borrowers from paying off the entire loan before it is due. For example, if interest rates decrease, borrowers may desire to prepay the balance of their loan while they can do so at a lower interest rate and avoid paying higher rates later, provided they have the financial means at the time of the interest rate reduction.

The Mortgage Bankers Association (MBA) found in its quarterly *National Delinquency Survey* that the total delinquency rate as of the third quarter of 2007 reached a peak since the organization began the study in 1986.²⁶ From the second to third quarter of 2007, the delinquency rate for prime loans rose from 2.73 to 3.12 percent and from 14.84 to 16.32 percent for subprime loans.²⁷ Thus, lenders or the investors to whom securitized loans were sold are increasingly facing the costs and burdens associated with subprime loans since they do not profit when a borrower does not make his or her interest payments.

²³ Tashman, *supra* note 6, at 409.

²⁴ *Id.*

²⁵ *Id.*

²⁶ Press Release, Mortgage Bankers Assoc., Delinquencies and Foreclosures Increase in Latest MBA Nat'l Delinquency Survey (Dec. 6, 2007) [hereinafter MBA Nat'l Delinquency Survey], *available at* <http://www.mortgagebankers.org/NewsandMedia/PressCenter/58758.htm> (Complete survey results are available from the organization at a cost).

²⁷ *Id.* (reported delinquency rate excludes loans in the process of foreclosure). Note that current MBA survey results are inherently limited because the organization tracks loans originated within only a three month period, which means that for example, loans that originated before or in the third quarter of 2007 that did not actually enter delinquency but are on the verge of doing so in the fourth quarter of that year will not be captured in currently reported data. This might lead some to believe that fewer loans are in danger than what might actually be the case.

B. Subprime Loans Are Not Inherently Abusive or Predatory

The terms “subprime” and “predatory” lending are frequently and erroneously used interchangeably to refer to abusive and unscrupulous lending practices.²⁸ While subprime loans certainly pose inherent financial risks, and lenders are susceptible to engaging in predatory practices, subprime loans are not inherently abusive or predatory but serve an appropriate function in the market.²⁹ In fact, the U.S. Treasury Department, Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) expressly approve of lending practices tailored to expand consumer access to credit through appropriate and responsible means.³⁰ For example, offering subprime loans that are reasonably priced, undergo sufficient underwriting, and are administered properly (i.e., without a lender unduly urging a borrower to obtain the loan and without any concealment of the loans risks and terms) could be beneficial to both consumers and lenders in the mortgage market.³¹

Yet some subprime lenders engage in predatory or abusive practices. Lenders engaging in predatory practices purposefully offer loans with exorbitant interest rates and unfavorable terms that it is highly probable that a borrower will default.³² Federal agencies define predatory lending as a practice that includes one or all of the following acts:

making unaffordable loans based on the assets of the borrower rather than on the borrower’s ability to repay an obligation; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees every time the loan is refinanced (“loan flipping”); or engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated

²⁸ FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 10-11.

²⁹ George G. Kaufman, *Credit to the Needy Needn’t be Predatory*, CHIC. TRIB., Aug. 26, 2000, at 23.

³⁰ FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 10-11.

³¹ *Id.*

³² Kaufman, *supra* note 29, at 23.

borrower.³³

Other practices that might be considered predatory are: imposing exorbitant interest rates and fees that do not reflect the actual credit risk the borrower poses; longstanding and excessive prepayment penalties that effectively hinder borrowers from prepaying the loan or refinancing when interest rates decrease or their credit report improves (so that they can obtain a prime or more suitable loan); and excessive loan-to-value ratios (the amount of the loan compared to the value of the property).³⁴

Some lenders structure these subprime loan transactions in a way that the borrower is at risk of losing one of his or her possessions of considerable value.³⁵ For example, some lenders extend loans to borrowers who they know, or should have known, have “little or no ability to repay the loan from sources other than the collateral pledged[,] . . . [and when the borrower defaults,] the lender forecloses or otherwise takes possession of the borrower’s property,” normally the applicant’s home.³⁶ Other lenders may use “the threat of foreclosure/repossession to induce duress upon the borrower” to urge him or her to maintain timely monthly payments and pay off any associated fees.³⁷ However, legitimate subprime lenders should recognize a borrower’s underlying credit risk and tailor a loan product to his or her risk level because the lender, or the investor to whom a securitized loan was sold, profits when the borrower pays off the loan until its maturity.

C. Subprime Mortgage Loans are Risky for Consumers

Although some consumers can afford and eventually repay their subprime loans, these loans inherently pose great risks because they often

³³ FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 10-11.

³⁴ Roberto G. Quercia et al., *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments*, 18 HOUSING POL’Y DEBATE 311, 313 (2007), available at https://www.mi.vt.edu/data/files/hpd%2018.2/5.hpd_quercia_web.pdf.

³⁵ See FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 10-11 (Some “lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value.”).

³⁶ *Id.* at 10.

³⁷ *Id.*

include unfavorable terms such as interest rate adjustments that increase to an excessive amount, prepayment fees, and other costs. Other risk factors include: a lender's inadequate underwriting, predatory lending practices, the unscrupulous behavior of lenders and brokers, lack of lender accountability, and inadequate oversight of the subprime mortgage market.

1. Terms of a Subprime Loan

The subprime market is intended to serve borrowers with blemished or no credit history or those preferring to secure relatively low monthly payments. Therefore these loans typically carry inflated interest rates after the first few months and payment penalties to protect lenders from the risks associated with subprime borrowers. Frequently subprime loans have a "payment shock" impact, beginning with an affordable interest rate that teases the consumer to think favorably about the loan but later escalates to an unaffordable price which many borrowers realize they can no longer afford.³⁸ Though the type of subprime loan varies with lenders, these loans generally come in the form of: interest-only loans, which for a specified period of time defer payment on the loan's principal; low documentation loans that permit borrowers with inconsistent credit or undocumented financial resources to submit partial records of their assets and income or other documentation that may indicate an ability to repay a loan; and payment option loans that suspend payments of certain interest amounts and aggregate those deferred payments into the accumulated principal due.³⁹ Some lenders offer Alt-A loans which incorporate "some combination of low documentation, slightly subpar credit scores, and features such as interest-only or payment options."⁴⁰ These Alt-A loans have terms tailored to borrowers with higher credit scores, and are not as risky as subprime loans.⁴¹ Alt-A loans represent an increasing proportion of all loan originations, rising from 2.7 percent in 2001 to 13.4 percent in 2006.⁴²

Yet the most frequently offered subprime loan is the "2/28"

³⁸ SCHLOEMER ET AL., *supra* note 15, at 26.

³⁹ ESSENE, *supra* note 3, at 1 n.3.

⁴⁰ 2007 HARVARD STUDY, *supra* note 2, at 17.

⁴¹ See *id.* (Alt-A loans "fall between prime and subprime loans on the risk spectrum").

⁴² *Id.*

adjustable-rate mortgage (ARM).⁴³ While the standard prime mortgage loan has a fixed interest rate for normally 30 years, the interest rate on ARMs varies over time and usually steadily increases.⁴⁴ Normally, the loan starts with an initial low teaser interest rate for the first two years and later increases by rate adjustments in six- to one-year increments for the next 28 years.⁴⁵ The 2/28 loans are sometimes termed “exploding ARMs” because of its serious payment shock effect on consumers due to often unexpected interest rate adjustments.⁴⁶

Vulnerable consumers, normally those with an ineligible credit history and/or in immediate need of a loan, are at risk because they may be tempted to obtain a loan because of the initial low teaser rate, but being unaware of, or under-appreciating the fact that it will increase over time.⁴⁷ When risky ARMs are used to buy or refinance a home, the borrower faces the dilemma of paying increasing monthly payments without actually increasing equity in his or her property.⁴⁸ Furthermore, many 2/28 loans include prepayment penalty clauses for payments made within the initial two-year fixed interest rate period or for even paying off the balance before the loan’s maturity date.⁴⁹ Nonetheless, borrowers are continuing to take out ARMs. As of the third quarter of 2007, ARMs increased to constitute 14.5 percent of all outstanding loans in the prime market and 6.8 percent in the subprime market.⁵⁰ Hybrid ARMs, which incorporate features of several loan types, constituted 81 percent of securitized loans in the

⁴³ See *id.* (“[A]most half of [the] securitized subprime debt originated in 2006 was in ‘2/28’ adjustable-rate loans[.]”).

⁴⁴ See *id.*, at 16 (“When the discounts expire, payments on recently originated adjustable loans will rise not only by the discounted percentage points, but also by any increase in the indexes to which the loan rates are tied.”).

⁴⁵ SCHLOEMER ET AL., *supra* note 15, at 26.

⁴⁶ *Id.* at 5.

⁴⁷ See GRAMLICH, *supra* note 11, at 17. (“[V]ulnerable and perhaps gullible borrowers can be tempted by teaser rates, low for two or three years but then much higher.”).

⁴⁸ SCHLOEMER ET AL., *supra* note 15, at 26.

⁴⁹ See GRAMLICH, *supra* note 11, at 18 (prepayment penalties are fees borrowers must pay if they pay off their entire loan before payments are due or if they make payments in any amount before a lender specified date); ESSENE, *supra* note 3, at 27 n.72. (“Most 2/28 loans have prepayment penalty clauses that apply to the 2 year fixed timeframe.”).

⁵⁰ MBA Nat’l Delinquency Survey, *supra* note 26.

subprime market as of the second quarter of 2006, an increase from 64 percent in 2002.⁵¹ Financial analysts predict that the amount of debt in the subprime market generated by ARMs in 2007 and 2008 alone could total \$482 billion.⁵²

Often subprime loans contain prepayment penalties that impose fees on borrowers for paying off all or a portion of the loan's balance before it is due.⁵³ Research indicates that prepayment penalties are attached to merely two percent of prime mortgages but 80 percent of subprime originations.⁵⁴ These excess costs present cyclical financial constraints, particularly for low-income borrowers, because those with insufficient funds to maintain their payments are penalized for not paying on time, and those trying to be prematurely released from their loan obligation face the difficult choice of incurring prepayment penalties. Nonetheless borrowers who decide to retain their subprime loan still face increasing and often unmanageable interest rate adjustments.

2. *Relaxed Underwriting Standards for Lenders*

The risks subprime loans impose on borrowers is compounded if lenders have insufficient underwriting standards, permitting them to issue loans without adequately considering the borrower's ability to repay the loan. Underwriting is the procedure lenders use to determine a potential borrower's credit worthiness and whether a loan should be extended; its purpose is to help lenders and borrowers avoid undue risk associated with the loan and prevent borrowers from entering into loans for which they are financially unsuitable.⁵⁵ It is encouraged as "best practices" that subprime lenders should employ underwriting standards that examine the effect significant loan payment increases might have on the borrower's capacity to repay the loan when it enters amortization, and lenders should advise the applicant or otherwise make a decision to approve or decline the loan based in part on that assessment.⁵⁶

⁵¹ SCHLOEMER ET AL., *supra* note 15, at 26.

⁵² 2007 HARVARD STUDY, *supra* note 2, at 3.

⁵³ See GRAMLICH, *supra* note 11, at 18.

⁵⁴ GRAMLICH, *supra* note 11, at 18.

⁵⁵ FED. DEPOSIT INS. CORP., CREDIT CARD ACTIVITIES MANUAL (2007), available at http://www.fdic.gov/regulations/examinations/credit_card/ch7.html.

⁵⁶ Interagency Guidance on Nontraditional Mortgage Product Risk, 71 Fed. Reg. 58609, 58613 (Oct. 4, 2006) [hereinafter Fed. Guidance on Nontraditional Mortgages].

When deciding whether to approve a loan application and originate a loan with certain terms, lenders should not look solely at a borrower's credit score but should also factor in the borrower's income, assets, and outstanding liabilities, especially for applicants that pose a risk due to insufficient income or excessive existing debt.⁵⁷ Yet some lenders regularly approve applications loans based on a borrower's ability to afford low initial interest rates though the lender knows the rate or cost of the loan factoring in other fees will eventually rise substantially, probably to a level which the applicant could no longer afford.⁵⁸ This practice sets unsuspecting borrowers up for financial crisis if they cannot maintain the payments. The U.S. Treasury Department, Federal Reserve Board, FDIC, and National Credit Union Administration (NCUA) seriously warn lenders against having relaxed underwriting standards or hiring other companies, who have different business goals antithetical to responsible and reasonable lending practices, to perform their underwriting.⁵⁹

The risks associated with relaxed underwriting standards are magnified when lenders do not require borrowers to allocate funds to escrow accounts to cover property taxes and hazard insurance, and permit applicants to submit little or no income documentation to obtain the loan.⁶⁰ Unlike the prime market where it is common practice to require escrow accounts and for lenders to consider these additional costs when determining whether to extend a loan to an applicant, many borrowers in the subprime market are led to falsely believe a loan is within their means because lenders might neither consider these factors when determining the applicant's suitability nor reveal true and often increased costs of subsequent interest payments.⁶¹

3. *Potential for Predatory Lending*

As discussed above, the availability of high-risk loan products in the subprime market and consumer demand for loan services despite his or her

available at <http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-8480.pdf>.

⁵⁷ *Id.* at 58614.

⁵⁸ SCHLOEMER ET AL., *supra* note 15, at 26.

⁵⁹ Fed. Guidance on Nontraditional Mortgages, *supra* note 56, at 58613.

⁶⁰ SCHLOEMER ET AL., *supra* note 15, at 27.

⁶¹ *Id.*

inadequate credit worthiness facilitates the opportunity for unscrupulous lenders to engage in predatory lending.⁶² Predatory mortgage lending occurs primarily in the subprime market, and lenders typically prey on senior citizens, low income applicants, and borrowers with substandard credit.⁶³ A borrower who becomes a victim of predatory lending normally pays excessive loan application or settlement fees, higher interest rates adjustments, or irrational prepayment penalties.⁶⁴

Predatory lending is becoming a common practice, and some lending institutions are being pursued in civil suits, some of which resulted in settlements.⁶⁵ Unfortunately, the legitimate subprime market suffers from such tainted practices, and legislators are working to regulate the mortgage industry and ensure adequate consumer protections.⁶⁶ In addition, while overt housing and lending discrimination decreased due to the nation's fair lending and civil rights laws, subtle forms of lending discrimination still exist. Practices such as providing or failing to provide certain information about a loan, steering customers towards a subprime loan, and even the selective showing of housing properties (i.e., one the lender know or should suspect that the applicant cannot afford but strongly might desire to purchase) can be suspect and are difficult to identify and regulate.⁶⁷

4. *Aggressive Lender Behavior*

⁶² See *supra* Part I.B (asserting that subprime loans are not inherently predatory).

⁶³ FED. BUREAU OF INVESTIGATION, U. S. DEP'T OF JUSTICE, FINANCIAL CRIMES REPORT TO THE PUBLIC 22 (2006) [hereinafter FINANCIAL CRIMES REPORT], available at http://www.fbi.gov/publications/financial/fes_report2006/publicrpt06.pdf; SCHLOEMER ET AL., *supra* note 15, at 27.

⁶⁴ FINANCIAL CRIMES REPORT, *supra* note 63, at 22.

⁶⁵ SCHLOEMER ET AL., *supra* note 15, at 28; see, e.g., Settlement Agreement and Order Thereupon, *United States v. Long Beach Mortgage Co.*, CV-96-6159 (C.D. Cal. 1996) (describing mortgage company's agreement to pay \$3 million to settle a complaint of discriminatory loan prices offered to African-Americans, Latinos, women, and persons over the age of 55, and the company's agreement to, among other things, develop and use a system to match applicants according to their risk classification and train mortgage brokers on fair lending practices and applicable laws).

⁶⁶ Senator Chris Dodd, Mortgage Market Turmoil: Causes and Consequences: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 110th Cong. (March 22, 2007) (statement of Sen. Chris Dodd, Chairman, S. Comm. on Banking, Housing, and Urban Affairs) [hereinafter Statement of Sen. Chris Dodd], (transcript available at <http://dodd.senate.gov/index.php?q=node/3795>).

⁶⁷ GRAMLICH, *supra* note 11, at 24.

Both legitimate and predatory subprime lenders aggressively solicit consumers, and although their marketing is permissible provided there are no misrepresentations or use of otherwise illegal tactics, many unsuspecting borrowers are induced to enter into such loans without full knowledge of its terms and implications. Some lenders use direct mailings, television and signs in neighborhoods, and some inappropriately mask their mailings to appear as government mailings to obtain the recipient's attention.⁶⁸ It is possible for applicants to be swayed to obtain a subprime when lenders make the application process seems so simple and market the services to be available to everyone, even those with poor credit records who were previously turned down by other companies. With advertising phrases like "Bad credit, no credit. Call Mortgage Lenders & Co. for quick approval" and other push-marketing techniques, lenders can induce applicants in serious need of a loan. Many consumers are exposed to and fall prey to these risks due to insufficient price awareness, and even those who might qualify for traditional prime loans might be induced to enter unfavorable subprime loans because of a lack of knowledge about the mortgage industry and other available loan options.⁶⁹

5. *Behavior of "Interested" Mortgage Brokers*

Included in the debate over who to blame for the negative consequences of subprime lending are mortgage brokers, many of whom are unregulated, and allegedly steer prospective borrowers into unaffordable loans, though lenders finally decide whether to originate the loan.⁷⁰ Banks and other lenders hire unregulated brokers to influence customers to take out their loans. Although many brokers transact in the standard prime market, the subprime market bears their greatest trail. Some researchers estimate that while only 25 percent of prime mortgage loan originations were opened through brokers in 2005, brokers were used in approximately 60 percent of subprime originations.⁷¹ Since mortgage

⁶⁸ Ronald H. Silverman, *Toward Curbing Predatory Lending*, 122 *BANKING L.J.* 483, 510 (2005).

⁶⁹ See ESSENE, *supra* note 3, at 26, 30.

⁷⁰ Les Christie, *Subprime Blame Game*, CNN Money.com.,

http://money.cnn.com/galleries/2007/real_estate/0704/gallery.paly_the_subprime_blame_game/index.html

(Last visited Dec. 16, 2007).

⁷¹ GRAMLICH, *supra* note 11, at 19.

brokers dominate marketing in the subprime arena, and since the number of subprime loan originations is increasing, lenders often give brokers incentives to get applicants to obtain their subprime loans.⁷² Brokers interested primarily in their commissions pose a danger to consumers.

On the one hand, the presence of brokers makes it arguably easier for consumers, especially lower income purchasers and consumers of color,⁷³ to access loans and information about their eligibility because brokers have an incentive to go out and attract prospective borrowers.⁷⁴ Since lower income consumers and some consumers of color are typically ineligible for prime rates or unknowledgeable about mortgage options, they are especially solicited by brokers. On the other hand, consumers are often victimized or otherwise uninformed actors because some brokers use aggressive sales tactics and tell consumers much about the low initial interest rates yet understate or completely fail to mention the eventual rising costs of these loans.⁷⁵ Reports indicate that some brokers go as far as orally promising borrowers that the initial teaser rates, for instance one to two percent, are permanent despite contrary language in fine print in the loan agreement.⁷⁶

6. *Lack of Accountability & Inadequate Oversight*

The lack of accountability for lenders and inadequate oversight of the subprime market also contributes to the inherent risks borrowers face in this market. The expansion of the subprime market is due largely in part to the securitization of mortgage loans.⁷⁷ Lenders typically gain more funds when they securitize private mortgage loans which enable them to extend credit to applicants who otherwise would be denied a loan.⁷⁸ The impact of securitization is that mortgages are now sold on the market to other

⁷² ESSENE, *supra* note 3, at 29.

⁷³ I use the term “consumers of color” and “borrowers of color” interchangeably to refer to a group of races and ethnicities that include American Indians or Alaska Natives, Asians, Blacks or African-Americans, Native Hawaiians or other Pacific Islanders, and Hispanic whites.

⁷⁴ GRAMLICH, *supra* note 11, at 20.

⁷⁵ Mara Der Hovanesian, *Nightmare Mortgages*, BUS. WK., Sept. 11, 2006.

⁷⁶ *Id.*

⁷⁷ Tashman, *supra* note 6, at 410.

⁷⁸ *Id.*

investors, and the risks associated with a mortgage are dispersed among many lenders, who provide the capital and thus the incentive to issue more loans to borrowers, fueling the subprime industry.⁷⁹ This risk dispersion and reduction permits lenders to remove themselves from some of the direct harmful consequences of subprime mortgage loans.⁸⁰

Furthermore, the subprime mortgage industry is lacking adequate oversight although legislators are taking measures to regulate lender behavior.⁸¹ Private lenders are not regulated as much as federal and other public lenders, and many of the existing regulations do not apply to all risky loan products.⁸² For example, the U.S. Federal Bureau of Investigation indicates there is no mandatory fraud reporting regulations for most principal actors (i.e., lenders and brokers) in the mortgage industry.⁸³ Regulation in the subprime mortgage market is lighter than in the prime market. Mortgages in the prime market are issued primarily by banks and thrifts, which are thoroughly regulated by the Federal Reserve Board, the FDIC, the Office of the Controller of the Currency (OCC), and the OTS.⁸⁴ These depository institutions are assessed every three years to evaluate the extent to which each institution assesses a borrower's ability to repay a loan, any possible lending discrimination, and the institution's lending records and disclosures under the Home Mortgage Disclosure Act (HMDA) of 1975.⁸⁵ In 2005, the three largest subprime lenders (Ameriquest, H&R

⁷⁹ ANTHONY DOWNS, THE BROOKINGS INSTITUTION, CREDIT CRISIS: THE SKY IS NOT FALLING (2007), *available at*

http://www.brookings.edu/~media/Files/rc/papers/2007/10_mortgage_industry_downs/10_mortgage_industry_downs.pdf.

⁸⁰ SCHILOEMER ET AL., *supra* note 15, at 6.

⁸¹ Statement of Sen. Chris Dodd, *supra* note 66.

⁸² DOWNS, *supra* note 79; SCHILOEMER ET AL., *supra* note 15, at 29.

⁸³ FINANCIAL CRIMES REPORT, *supra* note 59, at 21.

⁸⁴ GRAMLICH, *supra* note 11, at 20.

⁸⁵ *Id.* HMDA requires lending institutions with branches in metropolitan areas to publicly disclose their lending practices on certain loan originations. The disclosures include the geographic location, race, sex, and census tract of borrowers and other characteristics of the mortgage loans lenders originate or buy in a calendar year. Lenders must also disclose mortgage denial rates and the APR on high-priced loans (loans containing an APR three percentage points above the rate for a security with the same maturity as determined by the Treasury Department). Currently, the disclosures under the Act are the only data available to the public that reports characteristics of individual borrowers engaging in loan transactions. The disclosures are intended to help the public and its officials determine if such depository institutions are fulfilling their duty to meet

Block, and New Century Mortgage Corp.) were all independent institutions, formed under a state charter and not subject to much regulatory supervision.⁸⁶ The 2005 HMDA data reveals that 51 percent of subprime loans were made by unsupervised mortgage companies, 29 percent by slightly supervised subsidiaries and affiliates of supervised lenders, and merely 20 percent by completely supervised lenders.⁸⁷

II. CONSUMER BENEFITS & COSTS OF SUBPRIME LOANS

Subprime loans are intended for and benefit, at least in the short-term, needy applicants who cannot gain access to credit from the prime market. The innovative mortgage products emerging from the subprime industry enable borrowers to gain access to credit to which they might be otherwise denied. However, due to the risky terms incorporated in subprime loans, the expansion of subprime lending is associated with increasing consumer payment delinquency, home foreclosures, and bankruptcies.⁸⁸ Despite the benefits of subprime loans, researchers predict that many potential borrowers may delay purchasing or refinancing a home, regardless of if they have a subprime loan, until the mortgage credit markets become more certain.⁸⁹

A. Benefits of Subprime Mortgage Lending

When lenders exercise fair lending practices and consumers navigate the market armed with information and understanding about mortgage options, the subprime mortgage market benefits borrowers. Subprime applicants are typically low- to moderate-income consumers or those labeled as high risk borrowers due to their mediocre credit history.

the housing needs of the communities in which they are located, and to assist public officials enforce the country's fair lending laws and distribute public sector investments in a way to stimulate investment in the private sector. Home Mortgage Disclosure Act of 1975, 12 U.S.C. §§ 2801-2811 (2000).

⁸⁶ GRAMLICH, *supra* note 11, at 20.

⁸⁷ *Id.* at 20-21.

⁸⁸ See Press Release, Joint Ctr. for Housing Studies of Harvard Univ., Mortgage Market Complexity Foils Consumers and Undermines Fair Lending, Harvard Research Finds (Apr. 26, 2007), *available at*

http://www.jchs.harvard.edu/media/understanding_mortgage_markets_04-26-07.html.

⁸⁹ 2007 HARVARD STUDY, *supra* note 2, at 19.

According to economists, when the capital markets are efficient, consumers can make unobstructed decisions regardless of their cash on hand, and the recent innovation in the subprime market contributed to giving customers the ability to make purchasing decisions about housing.⁹⁰

The U.S. Treasury Department, Federal Reserve Board, FDIC, and OTS maintain that responsible subprime mortgage lending grants borrowers access to credit.⁹¹ Subprime lending extends credit to those who would otherwise be barred from receiving loans to make major purchases such as a home. In fact, these loans give borrowers the opportunity to create wealth, assuming they do not become subject to foreclosure or many of the other significant risk associated with subprime lending.⁹² An economist at the Brookings Institution observes that “[most] households appear to have benefited from being able to borrow more easily and cheaply,” and predicts that “[e]ven with the current problems [in the mortgage market], many households will avoid foreclosure.”⁹³ Consumers can use this credit to buy a home, refinance their mortgage, and finance other purchases. Consumers with little cash can liquefy the equity gained, if any, in their home to obtain more fund, yet as mentioned below, these funds may be unavailable if the borrower’s property value decreased or if he or she became delinquent on the payments.⁹⁴

From 1994 to 2003, the amount of subprime loan originations increased 25 percent per year, and prime market loans rose by 17 percent.⁹⁵ In that same period, the homeownership rate expanded from 64 to over 68 percent.⁹⁶ It is estimated that from 1995 to 2004 about 9 million consumers

⁹⁰ Austan Goolsbee, ‘Irresponsible’ Mortgages Have Opened Doors to Many of the Excluded, N.Y. TIMES, Mar. 29, 2007, at C3.

⁹¹ FED. GUIDANCE FOR SUBPRIME LENDING, *supra* note 18, at 1.

⁹² Tashman, *supra* note 6, at 407.

⁹³ DOUGLAS W. ELMENDORF, THE BROOKINGS INSTITUTION, NOTES ON POLICY RESPONSES TO THE SUBPRIME MORTGAGE UNRAVELING 10 (2007), available at http://www.brookings.edu/~media/Files/rc/papers/2007/09subprimemortgageunravelling/09useconomics_elmendorf.pdf;

but see *infra* Part II.B.3 (asserting that subprime lending contributed to an increase in foreclosure rates).

⁹⁴ 2004 Annual Roundtable Remarks, *supra* note 17.

⁹⁵ *Id.*

⁹⁶ *Id.*

purchased a new home.⁹⁷ However, research has yet to reveal whether subprime mortgage lending actually caused an increased in homeownership.

In addition, the subprime market lending arguably opened doors for many who experienced difficulty obtaining loans, particularly African-Americans and Hispanics.⁹⁸ According to Harvard University's latest national housing report, homeownership rates increased for all consumers of color overall (defined as African-Americans, Hispanics, and Asians/Other in this study), rising from 43.7 percent in 1995 to 51.3 percent in 2006, and in particular, the percentage of African-Americans owning homes grew from 42.9 to 48.4; Hispanics experienced a growth from 42 to 49.7 percent.⁹⁹ As discussed in greater detail below, various studies reveal that consumers in predominantly African-American and Hispanic areas are much more likely to have a subprime loan than borrowers in majority white areas, and in some neighborhoods the percentage of African-Americans and Hispanics with subprime loans is 40.7 and 28.6 respectively.¹⁰⁰ The confluence of these two observations suggest there might be a correlation between consumers of color accessing mortgage loans through subprime lending and the increasing rate at which these groups are purchasing homes.

Subprime lending may also provide consumers with a method of credit repair. If consumers with such loans regularly satisfy their payments at or above the minimum amount due and eventually pay off the loan, they might demonstrate responsible financial management to improve their credit score so they can later transact in the prime market. Yet this access to credit comes at a cost, though informed consumers may avoid many of them.

B. Costs of Subprime Mortgage Lending

While the subprime market expands the pool of borrowers who can qualify for mortgage loans, consumers who enter this market unaware of the risks, who know or should know that they are unsuitable for such loans, or who are induced into the market by unscrupulous lending practices, often incur unbearable costs such as excessive mortgage debt and increased

⁹⁷ *Id.*

⁹⁸ *But see infra* Part IV (explaining how many borrowers of color are disproportionately and negatively impacted by subprime mortgage loans).

⁹⁹ 2007 HARVARD STUDY, *supra* note 2, at 36, Table A-5.

¹⁰⁰ *See infra* Part IV.

susceptibility to delinquency and foreclosure. Thousands of borrowers were or might be forced to default and fear foreclosure because they cannot afford the ARM loan terms, and several major subprime lending institutions filed for bankruptcy because they are no longer profiting since their customers are not paying off their loans.¹⁰¹

1. Increase in Mortgage Debt

Home mortgage debt is a major source of debt for homeowners, and from 2000 to 2006 such debt expanded from 65 to 73 percent of all household outstanding debt.¹⁰² Moreover, an increasing proportion of households are consuming much of their income paying off home debt, and for many, the debt exceeds their personal income. Data from 1995 through 2004 indicates that almost two million more households are spending more than 40 percent of their income on debt, a percentage increase from 8.5 to 9.3 percent.¹⁰³ The convergence of these two observations indicates why subprime loans can be so risky. If borrowers are spending substantial proportions of their income servicing home debt, they will be shocked to discover that if they cannot satisfy the loan terms they might face losing their entire financial investment associated with the purchase, paying exorbitant loan related fees, and potentially losing their home.

Furthermore, consuming substantial proportions of income on debt servicing may deprive particularly low-income borrowers of finances needed for other purposes, like food, childcare, and medical expenses.¹⁰⁴ Low- to moderate-income borrowers and consumers of color may be disproportionately affected since these groups tend to have lower median incomes than their white counterparts or wealthy borrowers. Borrowers may also face personal bankruptcy at increasing rates, particularly those who use their mortgage loan to consolidate other debt.¹⁰⁵

Interestingly, subprime mortgage loans have two contrasting effects on personal bankruptcy. On one hand, since the subprime market increases access to credit, especially for consumers in financial need or those who would otherwise not qualify for standard loans, consumers in a financial

¹⁰¹ Tashman, *supra* note 6, at 407-408.

¹⁰² 2007 HARVARD STUDY, *supra* note 2, at 18-19.

¹⁰³ *Id.*

¹⁰⁴ Silverman, *supra* note 68, at 528.

¹⁰⁵ *Id.* at 529-30.

crisis might be able to borrow against their home equity to give them extra cash so that they do not have to declare bankruptcy.¹⁰⁶ It must be noted however that this benefit might not be realized by some borrowers whose homes were purchased or refinanced with subprime loans but did not accumulate much equity because the borrower did not make his or her monthly mortgage payments. On the other hand, since the costly rates and fees involved with subprime loans create the potential for borrowers to consume substantially all of their personal wealth servicing debt, this may force some to declare bankruptcy.¹⁰⁷ Moreover, a caveat to the benefit scenario is that home equity loans are secured by a lien against the borrower's home; so if a homeowner borrows against this equity and cannot repay the loan, he or she is at risk of losing the home to foreclosure.

2. Increase in Payment Delinquency

Economists indicate that when home prices began to decline after the homeownership rate peaked in 2005, there was an increase in the rate at which borrower began to default on their subprime loans, though subprime loans still represented a minority of all mortgage loans.¹⁰⁸ Researchers at Harvard University purport that subprime loans that were originated in the current market are at a high risk of eventual default.¹⁰⁹ As of March 2007, over seven percent of all subprime ARMs originated in 2006 were already at least 60 days delinquent or in foreclosure within six months from their origination.¹¹⁰

The 2007 MBA *National Delinquency Survey* found that the total delinquency rate, not including loans in the process of foreclosure, is the highest since the organization began the study in 1986.¹¹¹ In the third quarter of 2007, the delinquency rate on mortgage loans for one-to-four-unit homes rose to 5.59 percent of all outstanding loans.¹¹² Consumers

¹⁰⁶ DEP'T OF HOUS. AND URBAN DEV. & DEP'T OF TREASURY NAT'L TASK FORCE ON PREDATORY LENDING, CURBING PREDATORY MORTGAGE LENDING 31-33 (2000), available at <http://www.huduser.org/Publications/pdf/treasrpt.pdf>.

¹⁰⁷ *Id.*

¹⁰⁸ DOWNS, *supra* note 79.

¹⁰⁹ 2007 HARVARD STUDY, *supra* note 2, at 18.

¹¹⁰ *Id.*

¹¹¹ MBA Nat'l Delinquency Survey, *supra* note 26.

¹¹² *Id.*

with both prime and subprime loans are increasingly defaulting, as the seasonally adjusted delinquency rate rose from 2.73 to 3.12 percent for prime loans and from 14.82 to 16.31 percent for subprime loans.¹¹³ The rate of serious delinquency (loans 90 days or more delinquent or in the process of foreclosure) increased from 0.98 to 1.31 percent for prime loans and 9.27 to 11.38 percent for subprime loans.¹¹⁴ A limitation of the MBA data is that the organization does not report what percentage of loans will be or have been delinquent, but only the share of which are delinquent within a given quarter of the year, thus the even the most recent data available may not accurately reflect the performance of subprime loans. While it appears that a majority of consumers with subprime loans do not become delinquent, the recent data suggest that the effects can be devastating for consumers who already defaulted or will default.

3. *Increase in Home Foreclosures*

Foreclosures in the subprime market have a distressing impact not only on individual households but on the economy as a whole when homeowners lose this vital financial asset and the social advantages of homeownership.¹¹⁵ For many households, home equity is the greatest financial asset. Foreclosure rates are influenced by a variety of factors such as a borrower's poor credit history and provision of little to no income and debt documentation in the loan application process, higher loan-to-value ratios and adjustable interest rates that rise to unbearable amounts, rising interest rates on the market and the deflating values of homes.¹¹⁶

Researchers at the Center for Responsible Lending contend that the 2005 housing boom concealed the substantial number of borrowers facing

¹¹³ *Id.*

¹¹⁴ *Id.*

¹¹⁵ SCHLOEMER ET AL., *supra* note 15, at 4; *see generally*, NAT'L ASSOC. OF REALTORS, SOCIAL BENEFITS OF HOMEOWNERSHIP AND STABLE HOUSING (2006), *available at* [http://www.realtor.org/Research.nsf/files/05%20Social%20Benefits%20of%20Stable%20Housing.pdf/\\$FILE/05%20Social%20Benefits%20of%20Stable%20Housing.pdf](http://www.realtor.org/Research.nsf/files/05%20Social%20Benefits%20of%20Stable%20Housing.pdf/$FILE/05%20Social%20Benefits%20of%20Stable%20Housing.pdf) (discussing benefits such as positive impact on educational achievement of children in the household and homeowner's greater probably of being civically involved in the local community, while acknowledging the existence of third variables that make the causative link uncertain).

¹¹⁶ Quercia et al., *supra* note 34, at 337.

difficulty maintaining their subprime loans.¹¹⁷ The Center predicts that one in five of all subprime loans originated in 2005 and 2006 will end in foreclosure, and borrowers with multiple subprime loans face an even greater risk.¹¹⁸ In the fourth quarter of 2006, almost 250,000 homes began to foreclose,¹¹⁹ and it is estimated that after foreclosures deplete homeowners' equity, it will cost borrowers overall approximately \$164 billion.¹²⁰

During the third quarter of 2006, the foreclosure rates for both prime and subprime loans increased.¹²¹ The majority of consumers borrowed the standard prime fixed loans which represented 63.1 percent of all loan originations and 17.6 percent of initiated foreclosure proceedings; 14.5 percent of all loans were prime ARMs of which 18.7 percent began to enter foreclosure.¹²² Subprime fixed loans constituted 6.3 percent of all loans and just 12 percent of all foreclosures started; and alarmingly, while subprime ARMs represented only 6.8 percent of all loans, they were 43 percent of all foreclosures started in the third quarter of 2006.¹²³

Foreclosure rates are also associated with the presence and duration of prepayment penalties provisions in a mortgage loan. Some research indicates that borrowers are more likely to lose their home to foreclosure if their loan contains longer prepayment penalties (three or more years; 23.6 percent of foreclosures) than loans where such penalty is absent (15.3 percent of foreclosures).¹²⁴ The foreclosure rates on loans with prepayment penalties lasting less than three years (19.9 percent of foreclosures) are 30 percent higher than loans without such penalties.¹²⁵ However, it is unclear

¹¹⁷ SCHLOEMER ET AL., *supra* note 15, at 3.

¹¹⁸ *Id.* at 3-4.

¹¹⁹ 2007 HARVARD STUDY, *supra* note 2, at 18.

¹²⁰ SCHLOEMER ET AL., *supra* note 15, at 15.

¹²¹ MBA Nat'l Delinquency Survey, *supra* note 26. Note as previously mentioned, that here the MBA data reflects only those foreclosures that occurred during a specific three month period, not those that foreclosed before or might foreclose after this period.

¹²² *Id.*

¹²³ *Id.*; see also Quercia et al., *supra* note 34, at 333 (suggesting ARMs have about a 25 percent greater risk of foreclosure than fixed-rate mortgages).

¹²⁴ Quercia et al., *supra* note 34, at 333-34 (data sampled from 30-year refinanced subprime loans originated in 1999; foreclosure rates reflect properties that were in foreclosure proceedings at least once).

¹²⁵ *Id.*

in which direction the causation runs. It could be that the presence and impact of prepayment penalties imposes extra costs in addition to the inherent risks of subprime loans, which in turns increases the likelihood that borrowers may lose their homes to foreclosure because they cannot afford the payments. Conversely, consumers who lack bargaining power, especially those who are uninformed and tend to be more vulnerable, may be more likely to seek or obtain subprime loans, which have a greater probability of containing prepayment penalties, and due to their limited understanding or vulnerability, they may be more likely make a home purchase and take out a loan beyond their means, eventually leading to a great risk of foreclosure.

Home foreclosures adversely affect the borrower and his or her surrounding community. Foreclosing on a property negatively impacts a borrower's credit record and can hinder his or her access to and ability to make certain transactions in the credit, educational, insurance, and other markets.¹²⁶ A borrower may also suffer embarrassment and psychological and emotional harm.¹²⁷ The external effects of home foreclosures inflict serious social costs. If a substantial proportion of homes in a neighborhood are lost to foreclosure and remain abandoned, this may contribute to blight in the area.¹²⁸ In areas that are already blighted, foreclosed properties can remain vacant for a long time because the area becomes unattractive to private consumers, and potential home purchasers and even realtors may not be interested in purchasing or renovating homes in the community.¹²⁹ This is especially significant in low-income areas where the community is already deteriorating and revitalization projects may not exist. The geographic concentration of foreclosed properties will have an adverse impact on surrounding properties because even occupied residences may experience a reduction in property value, and the community might not be as marketable or might even become stigmatized.¹³⁰ Nonetheless, the actual number of loans affected by the devastating costs of subprime lending is relatively low, although growing in most states, and some economists predict that many borrowers will continue to pay off their loans

¹²⁶ *Id.* at 315.

¹²⁷ *Id.*

¹²⁸ 2004 Annual Roundtable Remarks, *supra* note 17; Silverman, *supra* note 68, at 523-24.

¹²⁹ ESSENE, *supra* note 3, at 2.

¹³⁰ *See id.*; Tashman, *supra* note 6, at 413.

as long as unemployment rates do not rise substantially.¹³¹

III. CONSUMER PSYCHOLOGY & BEHAVIOR FACILITATES VULNERABILITY TO RISKS IN THE SUBPRIME MARKET

The blame for the problems associated with subprime lending does not fall on lenders or mortgage brokers alone, nor does it lie solely on the loan terms, but sometimes consumers consciously and subconsciously expose themselves to risks in the mortgage market. While it is evident that some consumers are induced into subprime loans by no fault of their own, others are criticized for negligently entering into terms they knew or should have known they were unable to satisfy.¹³² A significant issue facing consumers when deciding to take out a loan is whether they are adequately informed, meaning that they are given all the information about a loan and are counseled so that they understand its nature and terms, and whether they are both willing and able to comparison shop for the most suitable loan product and terms.¹³³

Some consumers recognize the risks involved with subprime loans but decide to take their chances and gamble on the market in order to achieve short-term benefits, for example access to capital or a home purchase, without recognizing and understanding the consequences associated with such risks. The emergence of the subprime market gives consumers the freedom to borrow more than necessary or at an exorbitant price, and some do so to their demise.¹³⁴ Particularly at risk are vulnerable borrowers, especially those with lower incomes, who may be compelled to obtain subprime loans, for new purchases or refinancing, in order to satisfy existing debt,¹³⁵ and many borrowers do not understand the loan terms and its associated risks or underestimate how much their interest rates can

¹³¹ See DOWNS, *supra* note 79.

¹³² Christie, *supra* note 70.

¹³³ Robert B. Avery et al., *The 2006 HMDA Data*, Fed. Reserve Bulletin A73, A77 (2007), available at <http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf>

(This is the most recent government report analyzing the data on lending practices and loan performance collected pursuant to the Home Mortgage Disclosure Act).

¹³⁴ ELMENDORF, *supra* note 93, at 10.

¹³⁵ Silverman, *supra* note 68, at 509.

increase, especially for ARMs.¹³⁶

Behavioral economics helps clarify why certain consumer behavior makes borrowers more vulnerable to market risks. First, consumer preferences for a particular product tend not to be fixed but can vary over time and depending on how the product is marketed.¹³⁷ A consumer's preference for a particular product may change depending on how the lender "frames" his or her sales pitch or the benefit or uses of the product, and because mortgage products are complex, sometimes "consumers are unsure which product best meets their needs, or even whether they need the product at all."¹³⁸ Second, due to the variations in loan features and the lack of transparency in projected loan rates, consumers frequently are not conscious of loan prices and the rate and extent to which it may change.¹³⁹ For example, some consumers erroneously believe that lenders are required to offer the lowest interest rate possible and most favorable loan terms, whereas no such requirement currently exists under law.¹⁴⁰

Third, it is often difficult for consumers to make choices that involve substantial risks which must be thoroughly understood and choices that have long term consequences and include payments over time.¹⁴¹ The average consumer might not seek much information about the loan since many do not buy or refinance a home often, and it may not seem worth it to spend much time and energy learning about the market when there is no expectation of transacting in it frequently.¹⁴² Finally, even the most skillful consumers find it difficult to shop for mortgages.¹⁴³ Mortgage loan options can contain several complex provisions, and the realization of the risks and benefits may often depend on projected analyses of future interest rate fluctuations and other circumstances like whether a consumer will be able to make his or her monthly payments on time in the next few years.¹⁴⁴ The

¹³⁶ ELMENDORF, *supra* note 93, at 10.

¹³⁷ ESSENE, *supra* note 3, at 12-14.

¹³⁸ *Id.*

¹³⁹ *Id.* at 14-17.

¹⁴⁰ See FED. RESERVE BANK OF BOSTON, KNOW BEFORE YOU GO . . . TO GET A MORTGAGE, available at <http://www.bos.frb.org/consumer/knowbeforeyougo/mortgage/mortgage.pdf>.

¹⁴¹ ESSENE, *supra* note 3, at 18-21.

¹⁴² *Id.*

¹⁴³ *Id.* at 21-23.

difficulty of weighing such options without the assistance of a professional may lead consumers to a simpler analysis of balancing benefits and risks associated with the loan that are expected in one to three years as opposed to a more longitudinal risk management approach.

IV. CERTAIN CONSUMER GROUPS ARE MORE VULNERABLE TO SUBPRIME & ABUSIVE LENDING

While the risk of subprime lending impacts all consumers holding such loans, borrowers of color and those residing in predominately non-Hispanic white neighborhoods bear the heaviest burdens. Low- to moderate-income consumers are also a disproportionate share of subprime borrowers, and the elderly, retirees, recent immigrants, and the less educated are among those particularly affected.¹⁴⁵ Yet the latest data collected under HMDA, the primary federal loan reporting regulation, reveals little variance in loan pricing by gender. In 2006, female applicants without a co-borrower were marginally less likely (30.9 percent) to receive a high-priced loan for a home purchase than male applicants without a co-borrower (32.3 percent).¹⁴⁶ Likewise, there was only a slight variance between the home purchase loan denial rates for both female (20.9 percent) and male borrowers (21.7 percent) without a co-signer.¹⁴⁷

Over thirty years ago one of the major financial issues facing

¹⁴⁴ See generally, John A. Weinberg, *Borrowing by U.S. Households*, 92 ECON. Q. 177 (2006).

¹⁴⁵ See Silverman, *supra* note 68, at 524, 527.

¹⁴⁶ Avery et al., *supra* note 133, at A96, Table 11, A97 (little differences existed both before and after controlling for factors related to individual borrowers and specific lenders, and the total number of sole female (1,021,006) and male (1,392,947) borrowers sampled for this data set was within a reasonable range). Note that the HMDA data does not account for whether the applicants were caretakers of children with whom they lived or were otherwise the head of the household. Further research is needed to reveal whether there are statistically significant loan differences for single mothers as opposed to single fathers or even male non-father borrowers who obtained a loan without a co-signer. Also note that the HMDA data compiled by Avery et al. is limited in the sense that it reflects information regarding only conventional first lien mortgages on one- to four-family site-built homes that are the borrower's primary residence, as opposed to a vacation home or secondary property. Raw lending data collected pursuant to HMDA can be accessed online from the Federal Financial Institutions Examination Council at <http://www.ffiec.gov/hmda/>.

¹⁴⁷ *Id.* at A98, Table 13 (after controlling for factors related to individual borrowers and specific lenders).

consumers in neighborhoods of color was “redlining” — the practice of “denying the extension of credit [within] certain geographic areas due to the income, race, or ethnicity of its residents.”¹⁴⁸ Some report that real estate brokers “allegedly dr[e]w red lines around districts where lenders would refuse to make loans,”¹⁴⁹ and banks also historically avoided establishing branches in communities of color and declined to offer loans in these neighborhoods.¹⁵⁰ Today, the issue is the alleged deliberate extension of credit on unfair terms or the overextension of credit to consumers of color, what some call “reverse redlining.”¹⁵¹ Redlining and reverse redlining, the newer form of housing discrimination, are prohibited by federal civil rights laws, including the Fair Housing Act (FHA).¹⁵² In addition, a number of predatory lending and redlining practices are prohibited by states and are being incorporated into state civil rights laws.¹⁵³

Various studies reveal that even when controlling for income,

¹⁴⁸ See *United Companies Lending Corp. v. Sargeant*, 20 F. Supp. 2d 192, 203 n.5 (D. Mass. 1998) (citing S. REP. NO. 103-169, at 21 (1993), reprinted in 1994 U.S.C.C.A.N. 1881, 1905).

¹⁴⁹ See GRAMLICH, *supra* note 11, at 24; see also *United Companies Lending Corp.*, 20 F. Supp. 2d 192, 203 n.5 (“The term was derived from the actual practice of drawing a red line around certain areas in which credit would be denied.”).

¹⁵⁰ Vikas Bajaj & Ford Fessenden, *What’s Behind the Race Gap*, N.Y. TIMES, Nov. 4, 2007, at 16 (referencing an analysis done by N.Y.U.’s Furman Center for Real Estate and Urban Policy that illustrates subprime lending differences in New York City neighborhoods); Manny Fernandez & Ford Fessenden, *Racial Disparity Found Among New Yorkers With High-Rate Mortgages*, N.Y. TIMES, Oct. 15, 2007, at B1 (referring to a Federal Reserve study showing that “neighborhoods where people tend to have lower credit scores also tend to [have] a greater concentration of high-cost loans.”).

¹⁵¹ See *United Companies Lending Corp.*, 20 F. Supp. 2d at 203 n.5 (defining reverse redlining); Bajaj, *supra* note 150; Fernandez, *supra* note 150.

¹⁵² 42 U.S.C. §§ 3601-3631 (2000); *Hargraves v. Capital City Mortgage Corp.*, 140 F. Supp. 2d 7, 20 (D.D.C. 2000) (asserting that redlining and reverse redlining violates the FHA); *Honorable v. Easy Life Real Estate Sys.*, 100 F. Supp. 2d 885, 892 (N.D. Ill. 2000) (construing the FHA to prohibit discriminatory practices such as reverse redlining, mortgage redlining, insurance redlining, racial steering and other practices directly affecting the availability of housing to consumers of color).

¹⁵³ See *McGlawn v. Pa. Human Relations Comm.*, 891 A.2d 757 (Pa. Commw. 2006) (recognizing predatory lending and reverse redlining as prohibited acts under the Pennsylvania Human Relations Act, which is the state equivalent of the federal Civil Rights Act, where the Commission found that mortgage broker and one of its principal officers violated the Human Relations Act by discriminating against complainants in mortgage loan transactions because of their race and the racial composition of their communities), *appeal denied*, 906 A.2d 545 (Table) (2006).

consumers in predominantly African-American areas are more likely to have a subprime loan than borrowers in majority white areas, and in upper-income African-American communities, consumers are 1.5 times more likely to have a subprime loan than borrowers in even low-income white areas.¹⁵⁴ Consumers of color are also more likely to have higher priced loans than their white counterparts.

HMDA data indicates that in 2006, African-American (53.7 percent), Hispanic white (46.6), and American Indian/Alaska Native (34.2) mortgage applicants received a greater proportion of higher priced home purchase loans than their non-Hispanic white counterparts (17.7).¹⁵⁵ After controlling for factors relating to the individual borrowers and specific lenders, the percentage point gap existing between these groups and non-Hispanic whites was 12.6, 6.3, and 6.8 for African-Americans, Hispanic whites, and American Indian/Alaska Natives respectively.¹⁵⁶ Notably, Asians had a lower rate of receiving high priced home purchase loans than non-Hispanic whites both before (16.8 percent) and after (16.8) controlling for borrower and lender factors.¹⁵⁷ In addition, after controlling for borrower and lender factors, the rate of mortgage loan denial for home purchases was higher among African-Americans (21.5 percent), Hispanic whites (17.5), and American Indian/Alaska Natives (18.2) applicants than their non-Hispanic white counterparts (13.1).¹⁵⁸ However, the denial rates among Asians (14.8) were slightly higher than that of non-Hispanic whites.¹⁵⁹

The lending statistics regarding Boston and New York City are particularly striking, though they do not amount to any conclusive evidence of racial discrimination. In Boston, a study found that 55 percent of African-American and Latino borrowers in the Boston metropolitan area

¹⁵⁴ See Office of Fair Housing & Equal Opportunity, Subprime Lending, Dep't of Hous. and Urban Dev., *available at* <http://www.hud.gov/offices/fheo/lending/subprime.cfm> (last visited Dec. 12, 2007); FURMAN CTR. FOR REAL ESTATE & URBAN POLICY, DEMOGRAPHICS OF NEIGHBORHOODS WITH THE HIGHEST AND LOWEST RATES OF SUBPRIME LENDING, N.Y. UNIV. (2007), *available at* <http://furmancenter.nyu.edu/documents/AnalysisofNYCNeighborhoodswiththeHighestandLowestRatesofSubprimeLending.pdf>.

¹⁵⁵ Avery et al., *supra* note 133, at A95-96, Table 11.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at A98, Table 13.

¹⁵⁹ *Id.*

had subprime loans for their single-family homes, while only 13 percent of their white counterparts took out such loans.¹⁶⁰ Researchers at New York University found that while the rate of subprime lending in New York City (now 19.8 percent of all loans) and among communities of color decreased slightly in 2006, African-American consumers (40.7 percent of all subprime borrowers in 2006) were almost four times more likely to have a subprime loan than white consumers (9.1 percent), and Hispanics were almost three times more likely (28.6 percent).¹⁶¹

The data suggest a correlation between race, space, and income. The top ten areas in New York City with the greatest share of subprime loans were populated predominately with people of color. For example, in University Heights, where 47.2 percent of all loans were subprime loans, African-Americans and Hispanics constituted 35 and 57.4 percent of the population respectively; the median income was \$22,000.¹⁶² In Jamaica, where 46 percent of all loans were subprime, African-Americans and Hispanics represented 76.5 and 13.7 of the population respectively, and the median income was \$45,000.¹⁶³ Whereas in the Upper East Side of Manhattan, where only 0.6 percent of loans were subprime, whites were 84.7 percent of the population, and the median income was \$74,000.¹⁶⁴

Not only do borrowers in communities of color represent a disproportionate share of subprime mortgage borrowers, but they along with borrowers in rural communities are more likely to receive subprime loans with prepayment penalties. Researchers at the Center for Responsible Lending sampled 1.8 million loan originations in areas with defined

¹⁶⁰ Kimberly Blanton, *A 'Smoking Gun' on Race, Subprime Loans: Fresh Evidence Shows Minorities in Boston More Likely Than Whites to Get Them When Buying Home*, BOSTON GLOBE, Mar. 16, 2007, at 1C.

¹⁶¹ Press Release, Furman Ctr. for Real Estate & Urban Policy N.Y. Univ., *New Housing Data Continue to Show Signs of Danger for New York City's Homeowners, Furman Center Analysis Concludes* (Oct. 15, 2007), available at

http://furmancenter.nyu.edu/documents/FurmanCenterHMDAAAnalysis_000.pdf

(Asians were 13.6 percent of subprime borrowers in 2006. The study is partly based on latest data released pursuant to the Home Mortgage Disclosure Act under which lenders must disclose certain lending information).

¹⁶² DEMOGRAPHICS OF NEIGHBORHOODS WITH THE HIGHEST AND LOWEST RATES OF SUBPRIME LENDING, *supra* note 153.

¹⁶³ *Id.*

¹⁶⁴ *Id.*

concentrations of non-white residents from January 2000 to July 2004.¹⁶⁵ After controlling for significant property, loan, and borrower characteristics such as credit history, they found that borrowers living in zip code areas with at least 50 percent of a non-white population were 35 times more likely to receive prepayment penalties than similarly situated borrowers in areas where non-whites comprised less than 10 percent of residents.¹⁶⁶ In areas with 25 to 49 percent of non-white residents, borrowers were 11.9 times more likely to receive prepayment penalties in their loan.¹⁶⁷

One study found that as compared with borrowers in cities, borrowers in rural areas have a higher rate of receiving subprime loans with prepayment penalty provisions lasting more than 36 or 60 months.¹⁶⁸ In 2002, compared to borrowers in the central cities of large metropolitan areas, borrowers in rural areas were 5.5 percent more likely to receive loans with prepayment penalties for a term of least 24 months, 8.6 percent more likely for a term of 36 months, and 20.2 percent more likely for a term of 60 months.¹⁶⁹

The question as to why these patterns exist remains unanswered and unproven. Some of the studies examining race in the mortgage industry are inherently disadvantaged because they lack details about the applicant's credit score, assets, down payments, and existing debt,¹⁷⁰ and federally mandated loan reporting under HMDA does not account for all factors that affect loan decisions, terms, and performance.¹⁷¹ Some possible

¹⁶⁵ Debbie G. Bocian & Richard Zhai, Ctr. for Responsible Lending, *Borrowers in Higher Minority Areas More Likely to Receive Prepayment Penalties on Subprime Loans* 1 (2005), available at http://www.responsiblelending.org/pdfs/r004-PPP_Minority_Neighborhoods-0105.pdf.

¹⁶⁶ *Id.* at 3, 6 (loans sampled were limited to those with penalty terms effective for three or more years, and the study's result were statistically significant).

¹⁶⁷ *Id.* at 2.

¹⁶⁸ John Farris & Christopher A. Richardson, *The Geography of Subprime Mortgage Prepayment Penalty Patterns*, 15 HOUSING POL'Y DEBATE 687, 699 (2004), available at [http://www.mi.vt.edu/data/files/hpd%2015\(3\)/hpd%2015\(3\)_article_farris.pdf](http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_farris.pdf).

¹⁶⁹ *Id.* at 709 (controlling for variables such as loan underwriting factors and type of loan).

¹⁷⁰ Fernandez, *supra* note 150.

¹⁷¹ Avery et al., *supra* note 133, at A94, A99. Note the data collected under this Act does not account for all loan originations in the country since depository institutions that originate loans and engage in refinancing are exempt from certain disclosure requirements if the institution has \$30 million or less in total assets as of their most recent

explanations are: the historical lack of wealth and income among racial and ethnic groups, the lack of preparedness of these groups to make a sufficient down payment on their new home to secure a lower interest rate, the tendency for many consumers in these groups to transact mainly with mortgage companies providing only subprime loans rather than full-service banks, the relative lack of banks in communities of color as compared to predominantly white-non-Hispanic areas, and the lack of financial literacy among communities of color.¹⁷² Some argue that the disparity of high-priced loans among lower-income communities and those of color might be economically justified, or at least further explained by the fact that blacks as a group tend to be worse off financially, particularly in terms of accumulated wealth, than whites.¹⁷³

V. RECOMMENDATIONS

As asserted above, there is nothing inherently predatory or abusive about subprime mortgage lending; however consumers need assistance in navigating this market. Although some social and economic ills are curable or at least alleviated by letting the market correct itself over time through supply and demand fluctuations and other forces, the issues presented in the subprime mortgage market cannot be addressed by a complete *laissez-faire* approach. While the ideals of a free market economy, including the freedom to contract into loan terms, are noteworthy and apt in some contexts, reform in the subprime prime market needs a slightly more active solution. Borrowers should learn how to navigate the market and seek help doing so, lenders and affiliated brokers should adopt best practices consistent with and above and beyond applicable legal standards, and the federal and state government should impose heightened yet reasonable oversight and accountability measures. Any response to curtailing the costs and problems associated with subprime lending must balance: (1) the desire for this market to operate effectively so consumers with a poor credit history or who are otherwise ineligible for large loans can still access credit

fiscal year. 12 U.S.C. § 2803(i) (exemption from itemized disclosures of the “number and dollar amount of mortgage loans and completed applications involving mortgagors or mortgage applicants grouped according to census tract, income level, racial characteristics, and gender”). Thus many smaller lenders are not required to report some of the information that might reveal or explain some of the variance in loan terms and performance among and between certain consumer groups.

¹⁷² See Bajaj, *supra* note 150; Ferdandez, *supra* note 150.

¹⁷³ See GRAMLICH, *supra* note 11, at 24.

with (2) the need to prevent lenders from preying on vulnerable borrowers, and with (3) the need to hold consumers responsible for their own decisions.

A. Consumer-Oriented Solutions

Among the most viable solutions for consumers are: offering and encouraging mortgage counseling, increasing financial literacy, and encouraging consumers to resist the temptation to make home purchases above their means or to enter loans without carefully analyzing the risks involved. Public and private groups in several states already have some form of mortgage counseling, but considering the escalating risks in the current subprime mortgage market, this service should be promoted more, especially in communities where consumers are particularly vulnerable. Disinterested, third-party mortgage counselors should be specially trained or knowledgeable about the mortgage industry so they can help consumers navigate the complex mortgage market and choose the best loan option suitable to their income and assets even if it means not obtaining a subprime loan. Counselors should be available in all major cities, and some should particularly target borrowers of color and those in less densely populated areas.

This counseling should also be available via a telephone hotline so consumers can get real-time advice tailored to their needs; this also helps consumers like the elderly who may not be able to travel to the counseling centers or do not know how to use the internet to seek information about mortgages. For the computer savvy, an online mortgage program might be created to not only disseminate information about particular loan products, but also to calculate and estimate loan prices and expected interest rate adjustments based on consumer inputted data.¹⁷⁴ As the calculation and risk assessment for mortgage products can be very complex, a limitation of the system is that it is difficult to predict a loan's performance for individual borrowers due to several factors that can influence the probability of default and assessment of late fees caused by a reduction in income, loss or incapacitation of a spouse or someone else providing financial support, or sudden medical and other significant expenses. However this program would allow consumers to obtain a rough estimate of how much their loan may cost over a certain period of time and with a certain loan product.

¹⁷⁴ See ESSENE, *supra* note 3, at 37 (recommending an interactive online mortgage counseling service like the real time travel information available on websites such as www.orbitz.com and www.expedia.com).

The role of providing these services should be assumed by both community and non-profit groups and the government. Community-based organizations (CBOs) can serve a critical role in helping consumers transact in the mortgage market. Housing-oriented CBOs may be described as “nonprofit providers of housing services, [homeownership] counseling, and foreclosure protection,” and can help consumers identify and evaluate mortgage options and even secure alternative funds to help borrowers avoid being locked into non-favorable loan terms.¹⁷⁵ Community development corporations (CDCs) were some of the first entities serving these functions, and are non-financial organizations that among other things renovate residences, locate lower income prospective homeowners, and help them finance their mortgage with reputable lending institutions; some of these organizations qualify for federal funding.¹⁷⁶

Newer organizations are community development financial institutions (CDFIs), which are chartered by the U.S. Treasury Department and aim to stimulate economic revitalization and community development in underserved populations.¹⁷⁷ Similar to CDCs, CDFIs provide a broad array of social services, but unlike CDCs, these organizations are financial entities that receive federal and private funds and financial services to assist low-income communities, and they offer nontraditional mortgages and loans along with extending credit to eligible consumers.¹⁷⁸ Although this program helps consumers navigate the mortgage market, the budget for the CDFI Fund, a financing program administered by the Treasury Department and the largest funding source for CDFIs, has been cut in half since 2001.¹⁷⁹ Thus backing from the non-profit sector can also help ameliorate problems and risks consumers face in the subprime mortgage market.

Organizations like the American Association of Retired Persons and Habitat for Humanity which service vulnerable groups like the elderly and low-income persons should offer literature and counseling support for potential borrowers, or at least refer them to appropriate resources. Mega-churches, especially the African-American church, whose members are

¹⁷⁵ GRAMLICH, *supra* note 11, at 30-32.

¹⁷⁶ *Id.* at 30.

¹⁷⁷ CDFI Fund - About the CDFI Fund, U.S. Treasury, http://www.cdfifund.gov/who_we_are/about_us.asp (last visited Feb. 17, 2008).

¹⁷⁸ GRAMLICH, *supra* note 11, at 30-31; Coalition of Community Development Financial Institutions, <http://www.cdfi.org/cdfi-info-1e.asp> (last visited Feb. 17, 2008).

¹⁷⁹ COALITION OF COMMUNITY DEVELOPMENT FINANCIAL INSTITUTIONS, CDFI FACT SHEET, http://www.cdfi.org/downloads/CDFI_Fact_Sheet.pdf.

particularly vulnerable to subprime lending, should take an active role in hiring or soliciting volunteer counselors for their parishioners, promoting responsible credit habits, and encouraging members to seek some type of credit or mortgage counseling. These churches tend to have the same amount or even more resources than community-based and local government entities, and many also utilize their tax-exempt status to secure critical government support through faith-based initiative funding.

For example, former U.S. Congressman Floyd H. Flake pastors the over 18,000 member Greater Allen Cathedral of New York which offers regular consumer finance and mortgage counseling to the predominantly African-American congregation.¹⁸⁰ Pastor Flake uses his political acumen and role model status in the community to obtain private and government funding, and his church offers a wide array of social welfare services. Abyssinian Baptist Church,¹⁸¹ one of the most historical African-American churches dating back to 1808, created the Abyssinian Development Corporation¹⁸² which among other things develops rental housing and homeownership opportunities for the residents of Central Harlem, New York.

Yet, a majority of CBOs are constrained by limited staff and funding; therefore government assistance is needed and should be employed to strengthen consumer protection. In addition to the continuance of government-sponsored housing programs, the budget appropriations for organizations such as CDFIs should be increased to a level that allows these programs to expand and strengthen their services to communities in need.

In Iowa, for example, Attorney General Tom Miller implemented a pilot mortgage assistance program and hired a local mediation service to

¹⁸⁰ The church, located in Jamaica, New York, is considered by many to be the model of faith-based community initiatives. The church also constructed a \$42 million senior citizen assisted living complex of 330 units and is currently building a commercial retail space with low-income housing units on top. Information on these and other Allen projects is available through the church's website. Greater Allen Cathedral of New York, <http://allencathedral.org> (last visited Feb. 19, 2008).

¹⁸¹ Pastor Calvin O. Butts, III led the church in funding a \$2.8 million program to acquire and renovate 26 apartment units for the homeless across the street from the church, helping to constructing a \$9 million senior citizens apartment building of 100 units, and renovating moderate income condominiums in conjunction with the New York City Partnership. The church is located in Harlem, New York. The Abyssinian Baptist Church, <http://www.abbyssinian.org> (last visited Feb. 19, 2008).

¹⁸² Abyssinian Development Corporation, <http://www.adcorp.org> (last visited Feb. 19, 2008).

establish a toll-free mortgage counseling hotline; this organization has already received over 4,000 calls and is working on about 520 mortgage cases.¹⁸³ President Bush recently announced a joint consumer protection initiative, the “HOPE NOW Alliance,” with the Treasury Department and the Department of Housing and Urban Development (HUD) that includes offering a toll-free 24-hour mortgage counseling hotline (1-888-995-HOPE) in multiple languages.¹⁸⁴ This organization pools members from the private sector to implement mortgage relief and counseling programs and claims to do so without taxpayer subsidies or government mandates.¹⁸⁵ The Bush Administration also aims to temporarily freeze interest rates for troubled borrowers, especially those with subprime ARMs.¹⁸⁶ However the Alliance is receiving much criticism as commentators contend that the Bush Administration is not doing everything it claims, that the hotline often merely instructs people to contact their lender, that the program helps only a portion of borrowers in serious delinquency or facing imminent foreclosure, and that the program’s short-term benefits do little to help borrowers with longstanding problems and a history of poor credit; some suggest that the government should rather be working to inform consumers about various loan options.¹⁸⁷

The drawback with a consumer counseling approach is that it assumes consumers will have not only the initiative but the time and means

¹⁸³ Press Release, Office of the Attorney Gen., Iowa Dep’t of Justice, New Iowa “Foreclosure Hotline” -- 877-622-4866 (Sept. 11, 2007), *available at* http://www.iowa.gov/government/ag/latest_news/releases/sept_2007/Foreclosure_Hotline.html; Vikas Bajaj, *How to Solve a Subprime Mess? An Iowan Says, Let’s Caucus*, N.Y. TIMES, Dec. 9, 2007, at 31.

¹⁸⁴ Press Release, Office of the Press Sec’y, The White House, President Bush Announces Private-Sector Plan To Help Struggling Homeowners, Calls On Congress To Join Administration In Acting (Dec. 6, 2007) [hereinafter Pres. Bush’s Homeownership Initiative], *available at* <http://www.whitehouse.gov/news/releases/2007/12/20071206-7.html>.

¹⁸⁵ *Id.* Note that since this initiative was recently implemented and the Bush Administration has yet to publicly release complete data about its performance, some of its aspirations and achievements are currently unconfirmed.

¹⁸⁶ Renae Merle, *Foreclosures, Lenders’ Preferred Fix*, WASIL POST, Jan. 18, 2008, at D01.

¹⁸⁷ See, e.g., Editorial, *Default Position*, L.A. TIMES, Feb. 13, 2008, at 24; Editorial, *Hope Later*, N.Y. TIMES, Feb. 11, 2008, at A20 (discussing the White House’s inadequate measures to address the mortgage crisis); Editorial, *Lifeline for Whom?*, N.Y. TIMES, Feb. 13, 2008, at A24; Merle, *supra* note 186 (describing consumer advocates’ criticism of the shortcomings of the Bush administration’s plan).

to seek such services. Even with the Bush Administration's new initiative and existing counseling programs, some consumers do not respond when they are contacted by these organizations or do not attend the programs.¹⁸⁸ Yet the policy balance for consumer responsibility should put the onus on borrowers to seek help to the best extent possible, and those completely unwilling to help themselves should be prepared to face the risks. This approach also requires the costly hiring or volunteering of counselors, and it necessitates uniformity in and accountability for the disseminated information.

Another limitation with this approach is that very few states, mainly North Carolina and New York, require or statutorily recommend mortgage counseling for risky mortgage loans, and there is currently no federal law mandating counseling for all risky mortgage products. For example, North Carolina requires borrowers seeking a statutorily defined "high-cost home loan" to receive mortgage counseling from a state approved counselor, and lenders must receive confirmation that borrowers received the counseling.¹⁸⁹ New York law requires only that before originating a high cost home loan, lenders and brokers recommend in writing that borrowers "consider financial counseling" and provide them with a list of state approved counselors.¹⁹⁰

One recommendation would be to urge all states to adopt legislation requiring some form of mortgage counseling for borrowers seeking high risk mortgage loans. The criteria for this mandate should be narrowly tailored as to not put an undue burden on too many consumers but expansive enough to ensure adequate consumer protection. Whether counseling is required should be based on some combination of at least the following four factors: (1) the level of risk associated with the loan, defined similarly to the North Carolina high-cost home loan statute,¹⁹¹ (2) the consumer's debt-to-income ratio so that persons whose outstanding debt plus that to be incurred by the mortgage loan far exceeds their income (by

¹⁸⁸ See Merle, *supra* note 186.

¹⁸⁹ N.C. GEN. STAT. § 24-1.1E(c)(1) (2007); § 24-1.1E(a)(4) (defining a high-cost home loan). The law also imposes other limitations on both lenders and brokers regarding high-cost home loans. § 24-1.1E(b) (setting limits on terms such as balloon payments and increased interest rates). If a mortgage broker brokers a high-cost home loan where the borrower was required to but did not receive counseling, the broker is jointly and severally liable. See § 24-1.1E(g) (liability for brokers for brokering loans that violate the limitation provisions and specified prohibitions).

¹⁹⁰ N.Y. COMP. CODES R. & REGS. tit. 3, § 41.3(a) (2006).

¹⁹¹ N.C. GEN. STAT. § 24-1.1E(a)(4), (6).

more than approximately 3.5 times) should be more likely to fall under this requirement, (3) the expected loan-to-value ratio with the prospective mortgage product so that the requirement is triggered if the loan amount far exceeds the value or projected value of the home, and (4) some measure of the borrower's current and projected income or other assets as evidence of an ability to repay the loan.

Like the North Carolina statute, lenders should have to receive notification that a prospective borrower fulfilled the counseling requirement before a risky loan can be originated. Although riskier subprime loans tend to be originated for borrowers in communities of color, this legislation should not enforce any mandates on residents of these areas by virtue of their residency alone. If so, the statutes might be construed as discriminatory on its face or in its application.¹⁹² This proposal would also require an appropriations bill for a substantial amount of funding to finance the creation or strengthening of state approved mortgage counseling in areas where none existed or operated inefficiently. Even with this proposal, the costs of compliance is high for some prospective borrowers, especially lower-income consumers, who may face a tough dilemma choosing whether to work extra hours to provide for their family or to spend that time attending a mortgage class.

Financial literacy and public awareness programs can also help consumers gain information about the mortgage industry. The government should continue to offer literature and other homeownership information through HUD and distribute it to CBOs and churches so they can disseminate it to borrowers in their area. Banks should also have their own or government-produced materials available for consumers on-site and free of charge. The Bush Administration reports that the HOPE NOW Alliance recently mailed notification letters to hundreds of thousands of borrowers who fell behind their mortgage payments.¹⁹³ Some criticize this approach citing that it will lead to information overload, that less educated borrowers may not understand the material, and that consumers will need to receive this information so far in advance of a obtaining a mortgage loan and will

¹⁹² For example, if the application of the statute required all residents of County X, a predominately Hispanic area, to have counseling, and residents of County Y, a predominately white area, were not required to attend counseling (regardless of the lending and income records of both geographic areas), the law might be interpreted as discriminating against all Hispanics, or arguably against whites, or the residency trigger might be construed as a proxy for race.

¹⁹³ Pres. Bush's Homeownership Initiative, *supra* note 184.

not benefit if the information is not released timely.¹⁹⁴ While borrowers, especially the more vulnerable, inherently have less bargaining power in mortgage transactions, these measures can help consumers navigate the mortgage market.

Whether specially tailored initiatives, besides regulating and holding lenders accountable, are needed to address the racial disparities in the subprime mortgage market is a more difficult issue. The available data is does not isolate the causes of this disparity and is complicate by the fact that subprime lending might also help consumers of color make their first home purchase or otherwise gain access to credit.¹⁹⁵ A feasible approach, like the aforementioned recommendations, must center on the consumers but also apply reasonable, but not excessive oversight and accountability for lenders and brokers.

To this end, mortgage counseling and financial literacy and public awareness programs should place particular emphasis on communities of color. Local residents and the government should also appeal to and put pressure on banks to establish more branches in these neighborhoods, even if the legislature passes non-binding resolutions expressing the sense of Congress and the Senate that banks should some bear some social responsibility for offering financial products in diverse areas. However, besides discrimination, one of the reasons banks traditionally avoided these communities still exists — banks in many of these areas may not be as profitable since local consumers tend not to have as much income and wealth to invest in the bank and may have a questionable ability to repay a bank loan, and there tends to be a lack of local high-end business consumers to use the bank for corporate ends. Finally, although the subprime mortgage market can help many borrowers, some consumers, especially the most vulnerable and those aware of their inability to maintain a loan obligation, should not obtain a subprime loan even if it means forbearing an opportunity to achieve the American Dream with a first home purchase. Inevitably, initiatives will have to empower consumers to make the best informed choices and teach them responsible financial management.

B. Lender-Oriented Solutions

¹⁹⁴ See Silverman, *supra* note 68, at 569-70.

¹⁹⁵ See discussion and notes accompanying Part II.A (homeownership rates among consumers of color) and Part IV (subprime mortgage lending among consumers of color).

No policy solution can effectively address the risks consumers face in the subprime market by putting the burden on consumers alone. The subprime mortgage market needs government oversight, and lenders and brokers should be held civilly accountable through fines, mandatory financial contributions to consumer education programs, and other penalties. However, any reform in the subprime mortgage market must strike an adequate public policy balance. An unleashed activist state with too much regulation might overburden the market because lenders may be wary about originating subprime loans due to increased exposure to liability, and as a result fewer consumers in need may be extended credit.

Lenders and their affiliated organizations should work to adopt standard best practices for originating subprime loans. While the legislature is apt for setting and enforcing lending standards, organizations such as the National Association of Mortgage Brokers and the government-sponsored enterprises, mainly Fannie Mae and Freddie Mac, should promote a higher standard of best practices. In fact in some cases the best practices should be above and beyond statutory obligations since future laws might not reach that far into the industry due to policy concerns.

State laws should mandate heightened underwriting standards for originating subprime mortgage loans. Lenders and brokers should be required to thoroughly assess a consumer's ability to repay a subprime loan within a reasonable amount of time; such underwriting should include examining credit scores, current and projected income, and debt-to-income ratios. Consumers should also be required to submit income verification when submitting an application for a subprime mortgage loan. State law should impose a reasonable duty of care that lenders, brokers, and their agents owe to consumers, and also require lenders and brokers to be trained on their duties and lending responsibilities, including the application of, obligations, prohibitions, and potential liability under the federal Fair Housing Act¹⁹⁶ or the equivalent state housing and civil rights laws. Lenders and brokers should enter every mortgage transaction understanding their duty to consumers and that their actions may subject them to individual liability, judicial sanctions, and/or administrative sanctions.

As a best practice, lenders and brokers should implement a monitoring system to track all loan originations and their performance with complete consumer data, including race, gender, geographic area, and income and debt levels. This data should be systematically compiled and

¹⁹⁶ 42 U.S.C. §§ 3601-3631.

reviewed, at least on a biannual basis, by senior management of the institution. Examiners should look for any material patterns of price discrimination, including unfavorable loan terms, steering certain consumers into the subprime market, and other practices directly affecting the availability of credit to consumers of color. If these material results are unjustifiable by the borrower's underlying credit risk or are otherwise unexplainable by the lender or broker, one or more of the following actions should be taken to the extent necessary: issuing a private warning to the employee and a public notice of questionable lending practices in the workplace, reducing the lenders pay or the broker's commission, or suspending or terminating that employee to the extent allowable under any existing employment agreement. Finally, lenders and brokers should be required by law to report all lending data to the appropriate federal agency, and these results should be included in the HMDA reports.

VI. CONCLUSION

The U.S. subprime mortgage market offers credit to thousands of borrowers who otherwise are unable to obtain a large loan due to poor or little credit and other financial crisis. The emergence of subprime lending in the early 1900s now serves a legitimate role in the nation's economy and social structure, enabling borrowers to gain access to credit and home mortgage loans. Yet, these benefits come at a cost; subprime loans are inherently risky, some lenders engage in abusive and predatory practices, and subprime borrowers have a greater chance of incurring excessive mortgage debt, defaulting on their loans, and facing foreclosure.

While the subprime mortgage market is not inherently abusive or predatory, many unscrupulous lenders and brokers take advantage of consumers. Consumer behavior and demographics make some borrowers more vulnerable to these risks, and responses to alleviate the risks consumers face in this market must empower them to make the best informed choices. Furthermore, any policy initiative aimed at eliminating unfair and abusive lending practices must balance the desire for this market to operate efficiently with the need to prevent lenders from preying on vulnerable borrowers and the need to hold consumers responsible for their own decisions.